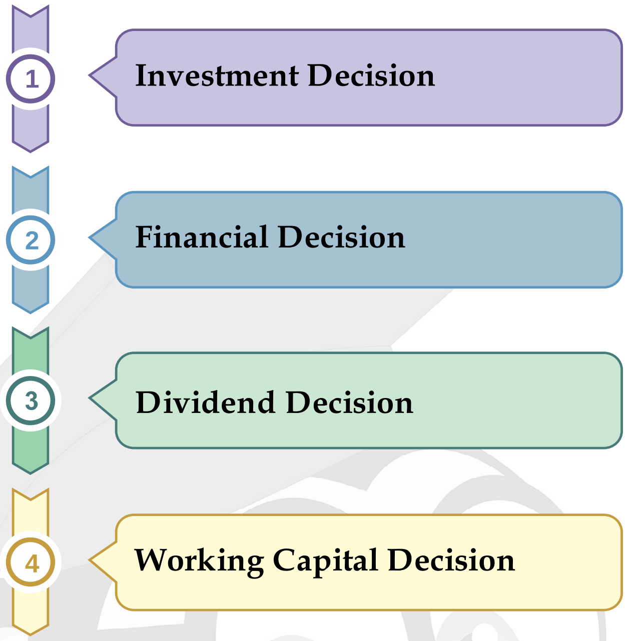
2. *Scope and Sources of Finance*

Scope of Business Finance

Some of the major scope of financial management are as follows:



1. Investment Decision

The investment decision involves the evaluation of risk, measurement of cost of capital and estimation of expected benefits from a project. Capital budgeting and liquidity are the two major components of investment decision. Capital budgeting is concerned with the allocation of capital and commitment of funds in permanent assets which would yield earnings in future.

Capital budgeting also involves decisions with respect to replacement and renovation of old assets. The finance manager must maintain an appropriate balance between fixed and current assets in order to maximise profitability and to maintain desired liquidity in the firm.

Capital budgeting is a very important decision as it affects the long-term success and growth of a firm. At the same time it is a very difficult decision because it involves the estimation of costs and benefits which are uncertain and unknown.

2. Financing Decision

While the investment decision involves decision with respect to composition or mix of assets, financing decision is concerned with the financing mix or financial structure of the firm. The raising of funds requires decisions regarding the methods and sources of finance, relative proportion and choice between alternative sources, time of floatation of securities, etc. In order to meet its investment needs, a firm can raise funds from various sources.

The finance manager must develop the best finance mix or optimum capital structure for the enterprise so as to maximise the long- term market price of the company's shares. A proper balance between debt and equity is required so that the return to equity shareholders is high and their risk is low.

Use of debt or financial leverage affects both the return and risk to the equity shareholders. The market value per share is maximised when risk and return are properly matched. The

finance department has decided the appropriate time to raise the funds and the method of issuing securities.

3. Dividend Decision

In order to achieve the wealth maximisation objective, an appropriate dividend policy must be developed. *One aspect of dividend policy is to decide whether to distribute all the profits in the form of dividends or to distribute a part of the profits and retain the balance. While deciding the optimum dividend payout ratio (proportion of net profits to be paid out to shareholders).*

The finance manager should consider the investment opportunities available to the firm, plans for expansion and growth, etc. Decisions must also be made with respect to dividend stability, form of dividends, i.e., cash dividends or stock dividends, etc.

4. Working Capital Decision

Working capital decision is related to the investment in current assets and current liabilities. Current assets include cash, receivables, inventory, short-term securities, etc. Current liabilities consist of creditors, bills payable, outstanding expenses, bank overdraft, etc. Current assets are those assets which are convertible into a cash within a year. Similarly, current liabilities are those liabilities, which are likely to mature for payment within an accounting year.

Sources of Business Finance

The sources of Finance are :

A. Internal Sources of Business Finance

B. External Sources of Business Finance.

A. Internal Sources of Business Finance

The internal sources of business finance include the following :

1. Short-Term (Working) Capital and
2. Long-Term (Fixed) Capital.

1. Short-term (Working) Capital: Banks are the providers of relatively short-term loans. A typical bank loan is often described as a '**self-liquidating**' loan, because it finances the purchase of raw materials which are transformed into saleable products within a few weeks or months.

Banks also provide 'bridge finance', finance required to wipe out temporary deficits which arise during periods when expenditures exceed receipts.

Nowadays commercial banks are much flexible in the length and purpose of their lending. Medium and longer-term loans are supplied to industry and commerce. The banks also provide finance for industry indirectly, through their ownership of finance companies and other financial institutions.

DID YOU KNOW ?

Working capital is the financial lifeblood of an enterprise and insufficient working capital is a frequent cause of failure. Maintenance of an adequate flow of working capital is, therefore, a first duty of the finance function to ensure funds for continued operation.

The definition usually applied to working capital is that it is the excess of current assets over current liabilities. In other words, it is the total of assets, liquid or easily made liquid such as cash, trade debtors, finished stocks of raw materials and semi-finished goods, over liabilities

that have to be met at short notice or in the normal course of business (certainly within one year) such as trade creditors, rent, rates and similar commitments.

Insufficient working capital may indicate over-trading and can result in the demise of the organisation. When profits and surplus cash have been turned into fixed assets in pursuit of expansion the result can be a lack of ready funds to meet immediate liabilities, technically a state of insolvency.

The same conditions can arise by being too lenient with debtors or by over-stocking, and by incurring debts with suppliers or the banks which cannot be matched by incoming current revenue.

The need to forecast the amount of working capital to be devoted to new project is particularly important, and this should be provided when cash budgets are being worked out. Failure to make adequate provision restricts the amount of research and development that can be financed and thus is detrimental to the continued success of the enterprise.

Very often the development of a new product requires the design and development of special tools, jigs and ancillary equipment and the necessary expenditure on these aspects of a new project must be accepted as a charge on working capital rather than as a charge against capital expenditure.

There are two reasons for this. The first is that the control of revenue expenditure is more easily delegated to a department than capital expenditure and second, that development costs usually arise piecemeal as their need becomes apparent and repeated applications for capital sums is an inconvenience administratively.

Any estimates and budgets for working capital must take into account two important factors: the current and probable future rates of interest and the probable trends in inflation. Both of these factors are beyond the control of the finance function, but must be included in the calculations of future working capital needs.

Inflation erodes the buying value of working capital and this reduction in purchasing power must be countered as far as possible by an adequate product pricing policy, the establishment of cost-reducing practices throughout the organisation, a strict control on credit and the wise investment of surplus funds. Borrowing also must be strictly regulated, especially at the time of high interest rates.

2. Long-term (Fixed) Capital : Fixed capital is normally provided by the stockholders and bondholders, while working capital required for investment in current assets may be supplied, at least partly, by banks or by the market for commercial (short-term) papers.

Fixed capital is regarded as tied up and consequently must be furnished permanently or for a long period of time. It is for this reason that stockholders and bondholders contribute fixed capital to a business.

However, there are some disadvantages of fixed capital. The debt must be repaid with interest. And the fixed interest charges may become a financial burden during periods of little or no earnings. The best way to obtain fixed capital is from funds provided by owners or creditors who will not be repaid for several years.

Regardless of the form of business organisation and ownership, the following are the important sources of business capital:

1. Owner's equity capital (proprietorships and partnerships)
2. Sales of securities (stocks and bonds)
3. Retained earnings (reinvestment of profits)
4. Lease financing (lease contracts).

Funds originally contributed by the owners as partners or shareholders are classified as net worth and make up the equity capital.

Retained Profits

By far the most important source of company finance is internal. A major portion of the capital funds of large quoted companies (i.e., companies whose shares are dealt with the stock exchange) derives from retained profits. Even in the case of a smaller company most of the capital requirements are generated within the company.

A prudent policy of retaining a proportion of the profits within the organisation instead of distributing them entirely as dividend or other earnings to owner can build up funds for working capital or short-term capital projects. These retained profits can be invested for a return until they are needed.

In fact, not all profits are distributed among the shareholders. In addition to providing for depreciation and for a contingency fund profits will be regarded by a successful company as its major source of capital for future expansion.

B. External Sources of Business Finance

When a large amount of capital is required, the first step is usually to form a public company. But it is the second step which is really important – getting its share quoted on the Stock Exchange. In fact, as for a larger organisation (or a firm) a major source of capital is the new issue market. Large sums of money can be raised by selling shares and debentures to the public.

The most important source of long-term capital, if the amount is large one, is a share issue, either in the market and offered to investors generally or offered specifically to existing shareholders often in proportion to their existing holdings. The last method is called a 'rights issue'.

Such finance is, of course, permanent. In this finance if once share is issued, it cannot be bought back by the issuing company. Small firms have limited amount of funds which they can raise. Therefore long-term financing for these firms is usually done from fixed asset mortgages and from other forms of debt capital. Beginning a business on a limited budget is risky due to limited availability of funds to operate the business.

Big corporations have a distinct advantage, since they are able to sell securities through the capital market (by making public issues). Another alternative for larger business is to issue long-term credit instruments such as bonds and debentures. Fig. shows various sources of long-term funds and their advantages, for which these funds are used.

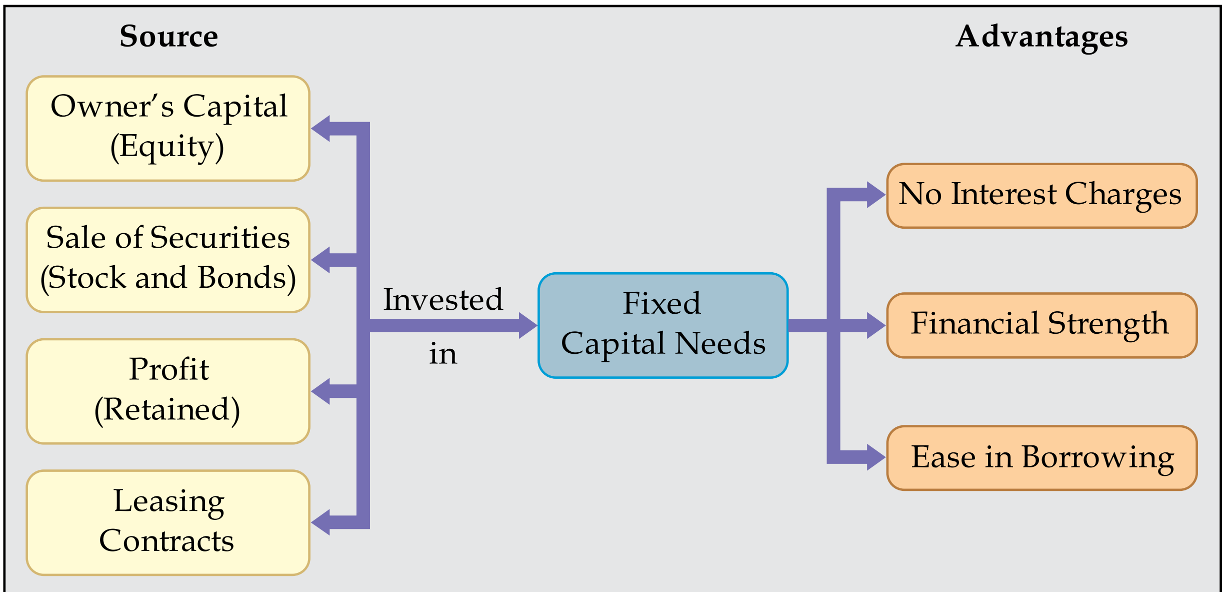


Fig. : *Long-Term Capital Financing Source*

Equity Financing

Equity is the ownership claim to the resources of the firm.

Ownership can be either :

(1) The initial funds or services contributed by the owner,

(2) The additional money contributed later, or

(3) The reinvested profits earned by the business.

1. Shares

A share is exactly what the name implies, a participation in the provision of the capital of a company. It is of two types: ordinary shares and preference shares.

(i) Ordinary Shares : *The dividend paid to the ordinary shareholder depends mainly on the prosperity of the company.* If profits are high, the dividend is usually correspondingly high. If there are no profits, then there may be no dividend. Moreover, the payment of a dividend to an ordinary shareholder ranks last in the order of priority.

Furthermore, if the company goes into liquidation the ordinary shareholder is repaid only after other creditors have been paid in full. Thus the 'ordinary share' is termed 'risk capital' (and often referred to as 'equity'). In return for bearing the risks of the business venture each ordinary shareholder has a say in the running of the company, voting according to the number of shares held.

Thus, it is the ordinary shareholders who take the major risks and decisions regarding the policy of the company. So they are the real entrepreneurs. Moreover, unless a company is very large, the directors are often in a strong position in that they may hold or control a large proportion of the ordinary shares.

The use of equity financing offers the following advantages :

1. *There are no interest charges to be paid to the owner.*
2. *A firm financed by equity capital is financially stronger and better able to withstand a business recession than one that uses debt.*
3. *Assuming the firm is well financed in the beginning, the owner's ability to obtain borrowed capital is improved.*

However, one major disadvantage is that equity financing is not always a dependable and available source of money. Then, too, the owner may find it difficult to obtain more funds in sufficient quantities to meet various needs. Adding a partner does not always prove to be rewarding.

(ii) Preference Shares : *If investors wish to undertake very little risk, they can buy preference shares. Such a shareholder is entitled to a dividend payment before the ordinary shareholder*, but only at a fixed percent no matter how high the company's profits.

Moreover, only in exceptional circumstances such as when it is proposed to alter their rights or to wind up the company or when their dividends are in arrears, can these shareholders vote at ordinary meetings.

If, however, a company is forced to go into liquidation, the preference shareholder ranks above the ordinary shareholder in the redemption of capital.

Another feature of preference shares is that these may also be 'cumulative'. If the company cannot pay a dividend one year, arrears may be made up in succeeding years before the ordinary shareholders receive any dividend. In recent years, preference shares have lost popularity due to their unfavourable tax treatment.

Other forms of long-term finance, which will require repayment at some future date, are the following :

2. Borrowing

(i) Debentures : *Long term loans are usually obtained by issuing 'debentures'. These bear a fixed rate of interest irrespective of the profit made by the company.* These are really redeemable long-term loans at fixed interest and secured on the assets of the company. Since this interest payment is a first charge on the income of the company, the risk to the investor's income is not so high.

Moreover, in case of company failure, debenture-holders are paid out first. Debenture-holders secure certain rights over the borrowing firm which, in some, cases involve the right to sell off assets to secure repayment in the event of failure to meet interest payment as and when due.

In fact, 'mortgage debentures' are secured on definite assets of the company. Another advantage of debentures is that they are redeemable after a specified period. If the company is unable to meet its interest charges or to redeem the loan when due, the debenture-holder can force it into liquidation.

Where profits are expected to rise in the future, therefore, a company may prefer to raise capital for expansion by issuing debentures. But it is the present-day corporation tax which is the main impulse in this direction. Debenture interest is included in the costs of a company for the purpose of calculating tax.

Thus it reduces taxable profits. On the other hand, if finance is raised by shares, there is no prior interest charge and profits (which are subject to tax) will be that amount higher. This tax situation has, due to the introduction of corporation tax, led companies to finance capital expansion as far as possible by fixed-interest loans rather than by the sale of shares.

(ii) Bonds : *The traditional method of sale of bonds is widely used by corporations to obtain long-term financing.* A bond is a certificate of indebtedness indicating debt that is owed the bondholder by the corporation. It is a corporation debt that matures at a stated future date on which interest is paid annually or semi-annually.

Bonds may be at fixed or variable rates of interest and are repayable at a specific date. They are normally secured either on some asset or assets, or on a personal guarantee of someone of substance. Such loans do not as a rule attract any rights to the lender as do debentures. Bond financing generally attracts more capital than, that can be obtained by other forms of ownership. Corporations can issue more than one kind of bond to satisfy investors. Some investors choose to invest in bonds rather than in equities.

Financing by bonds offers several advantages :

1. *The sale of bonds does not affect management control. Unlike shareholders, bondholders have no voting rights.*
2. *Bond interest is a deductible expense for tax purposes.*
3. *Borrowing does not dilute the shareholders' equity because no additional shares are issued.*

There are some disadvantages of bond financing as well. The debt must be repaid with interest. And the fixed interest charges may become a financial burden during periods of little or no earnings.